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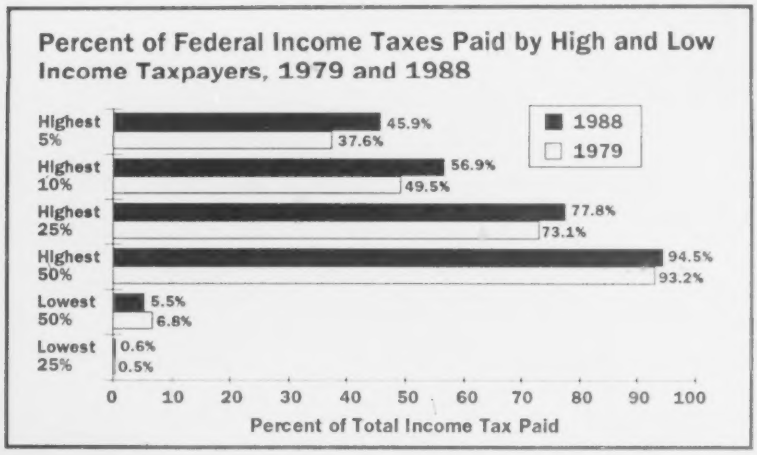
Tax Features

U.S. Income Tax Burden: Top 10% Pays Over Half; Top Half Pays Over 90%

The top earning half of the population continues to pay well over 90 percent of the federal individual income tax bill, according to analysis of the most recent 1988 IRS tax return data. 1988 data reflect the first year for which most provisions of the Tax Reform Act of 1986 (TRA'86) were fully implemented. Despite all the major tax legislation witnessed over the past decade, the top earning half's share of the tax load has varied less than 2 percent — from a low of 92.6 percent in 1982 to a high of 94.5 percent in 1988.



The federal income tax system remains progressive as the top ten percent of earners continue to shoulder a larger share of the total tax burden, up 7.4 percentage points, from 49.5 percent in 1979 to 56.9 percent in 1988. This growth in tax burden has occurred despite the alleged upper income bias of the tax cuts and rate reductions under the Economic Recovery Tax Act of 1981 (ERTA), and TRA'86.

Growth in the income base itself has been increasing faster at the upper end of the income scale, resulting in increased income tax receipts from top earners. The 110 million returns filed for tax year 1988 reported a sharp increase in adjusted gross income of over $323 billion, largely due to the fact that a number of income exclusions and adjustments were either

See High-Low on page 4

Tax Foundation

IN THIS ISSUE

High Earners Carry Tax Load	1
"Front Burner"	1
Viewpoint	3
Tax Policy Seminar	4
President's Message	5
Thomas M. Macioce	5
Research Planning Groups	5
Tax Foundation Seminar	6

FRONT BURNER

Pension Simplification: Is It Attainable?

Sen. David Pryor

Pension simplification is both desirable and achievable this year. The Finance Subcommittee on Private Retirement Plans has held two hearings to discuss pension simplification. The Ways and Means Committee staff has made recommendations to Chairman Rostenkowski on simplification proposals, including pension changes. Finally, on July 25, Representative Chandler and I introduced companion bills, S. 2901 and H.R. 5362, the Employee Benefit Simplification Act, as a first step toward improving the administrability of the nation's pension laws.

The broad Congressional interest has convinced many early doubters that the tax writing Committees are willing to undertake the laborious task of reviewing the Internal Revenue Code pension rules and, more importantly, are willing to grapple with the reality of drafting improvements to the system.

Today, there are two major questions in the minds of most benefits watchers. First, does the Employee Benefit Simplification Act really advance the cause of simplification? Second what is the likelihood of the Congress acting this year?

A quick look at the Employee Benefit Simplification Act would lead some to conclude that it might add to the complexity of the system: it totals 67 pages. However, a closer scrutiny shows that the bill accomplishes significant simplification in a number of areas.

S. 2901/H.R. 5362 replaces the complex distribution rules of present law with a simple rule that allows an employee to roll over any

See Pryor on page 2

David Pryor, Democratic Senator from Arkansas, serves on the Senate Committee on Finance.

Ed. Note: The Front Burner is a forum for participants in the fiscal arena to express their opinions on tax and budget issues. These opinions are not necessarily those of the Tax Foundation. Editorial replies are encouraged.

Pryor from page 1

portion of a distribution, provided the rollover is accomplished within 60 days. At the most basic level, this change will eliminate half of the statutory language dealing with pension distribution and many pages of regulations. But more importantly, this change will eliminate much of the confusion for employee participants on what is or is not allowed when a participant receives a lump sum distribution.

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Additionally, the bills would nullify the Treasury regulations on leased employees and replace them with a much narrower "control" test. The Treasury regulations use a "historically performed" test, which considerably increases the universe of workers an employer must consider as leased employees. The regulations are causing employers to expend hundreds of thousands of dollars on data collection without providing any more certainty that they are complying with the regulations. The control test of the bills would considerably narrow the pool of workers that might be considered leased employees, and, therefore, the proposed change would cut costs and provide more certainty to employers.

Another important component of the bill is a safe harbor for section 401(k) plans. The present rules governing 401(k) plans require costly testing every year to measure the deferrals of the high paid employees against the deferrals of the rank and file. The bills contain a safe harbor from this yearly testing for pension plans that provide generous benefits to the rank and file. This provision provides real relief to plans fitting within its requirements. It should cut costs for many plans, and encourage others to increase benefits to their employees in order to fit within the safe harbor.

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The bills' provisions are numerous, but overall, the general character of these changes is to draw simple bright line tests for employees with our compromising pension policy. These changes include simplifying the definitions of compensation and highly compensated employees, modifying the minimum participation requirements to focus the rules on the areas where abuses are more likely to occur, and changing the rules governing Simplified Employee Plans to encourage their use by small employers.

"The bills will not make the pension rules simple, but they will certainly make them simpler. We must clearly move in the direction of making policy clearer and more administrable; otherwise, we risk seeing a long term decline in retirement savings at the same time that changing demographics make it imperative that we save more."

All of these changes add up to real simplification. Most of them have been drafted to minimize disruption and the need for plan amendments. Where necessary, effective dates have been delayed to help employers to adjust to change. The bills will not make the pension rules simple, but they will certainly make them simpler. We must clearly move in the direction of making policy clearer and more administrable; otherwise, we risk seeing a long term decline in retirement savings at the same time that changing demographics make it imperative that we save more.

But is simplification achievable this year? Like all tax proposals before Congress this year, pension simplification is tied to the budget summit, like Captain Ahab to the great white whale. If the summit sinks below the waters, then pension simplification will have to wait for the 102nd Congress for revival. However, if the summiteers are able to keep an agreement afloat and the ground rules established by the summit permit, Congress is likely to address pension simplification this year. The cause is certainly helped by having a majority of the Finance Committee as cosponsors, including Chairman Bentsen.

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In addition, there is the very important consideration of revenue loss. Although the Joint Committee on Taxation has not yet completed a revenue estimate for the bill, we expect to receive them soon and are hopeful that the effect on the budget will not be significant. Moreover, to act on pension simplification this year, the summit agreement will have to provide some leeway for addressing non-budget issues. If the Employee Benefit Simplification Act can overcome these two potential hurdles, then it should have a good chance of being included in the budget agreement.

VIEWPOINT

With an extension of the tax credit for R&D once again under consideration, is it also time to simplify the administrative burden?

Research and development (R&D) expenditures are more than corporate operating expenses; they are an investment in future technological advances, in the competitiveness of U.S. industry, and ultimately in society as a whole.

The most critical legislative problem that R&D faces today is the uncertainty surrounding the continued existence of these incentives. The Omnibus Budget Reconciliation Act of 1989 extended the R&D credit through September 1990. Whether or not it will be extended again is certainly not guaranteed, especially given the current fiscal climate. Unfortunately, the government's short-term revenue considerations and corresponding R&D tax policy – i.e., the lack of a permanent credit – frustrate the long-term planning of research expenditures.

Given the integral part R&D plays in our country's economic development, it is surprising how uncertain and inconsistent its treatment in the tax code and by regulations, including the lack of a permanent credit, has been during the past decade. The rules governing application of the R&D incentives are quite complex and arguably more burdensome than necessary for an appropriate blend of tax policy and administrative practicality.

Allow me to illustrate this point with an example from my own experience with the taxation of R&D. For somewhat apparent reasons, when viewed from their single perspective, different authoritative bodies, such as regulatory agencies, have created significantly different definitions as to what R&D activities and expenses constitute "research and development" for their purposes. So, for instance, there are GAAP rules for measuring R&D for accounting purposes, government contract accounting rules for eligible R&D on government contracts, specific industry guidelines for R&D in certain industries, and a multiplicity of tax rules.

More specifically, however, once we focus on the tax rules, their construction seems to have been with limited reference to other definitional sources. Moreover, the tax rules rely on different definitions for different statutory applications. For example, the deduction under Section 174 is fairly broad, but the "qualified research" definition for the R&D credit of Section 41 is much more restrictive and only applicable to a subset of expenses. In addition, during the last decade these definitions have been changed both statutorily and by regulation. For instance, it was only last year that final regulations were issued for applying many aspects of the credit, and these regulations incorporated some brand new interpretations retroactive to the original effective dates in 1981.

Imagine then the plight of a manufacturer with some government contracts, for example, who must maintain exhaustive records for distinguishing between the costs on a project-by-project basis that meet the varying definitions: GAAP for financial statements, government contracting regulations for government contracts, Reg. Section 1.174 for R&D deductions, and Section 41 and the regulations thereunder for the R&D credit. Of course, I've not mentioned what are perhaps the most important research numbers for this hypothetical manufacturer: the management reports used to properly administer the research project, which obviously could require an entirely different set of records.

Robert L. Black, Ph.D., CPA
National Tax
Coopers & Lybrand

While the objectives of having different defintions may make sense on a separate-purpose basis, the multiple definitions, when applied concurrently to the same projects, only create administrative confusion and inefficiencies. And the problem is not just within the private sector; IRS agents have similar difficulties with interpreting and applying the myriad of R&D rules.

The Tax Foundation recently conducted a seminar designed to illuminate the issues that companies face regarding research and development. The proceedings are now available, and as you read through the presentations of these lawyers, scholars, businessmen and government representatives, you may be surprised to learn that a company often reaps little direct or immediate benefit from its R&D spending, and that too frequently there may be no benefit at all. In that the credit percentage has been eroded over the years and the foreign allocation rules may produce a higher worldwide effective tax rate for U.S. multinational conducting research, it may seem surprising, from a tax standpoint, that companies commit the level of resources to R&D that they do.

Isn't it about time that we reevaluated our R&D tax policy to help ensure that the tax incentive effects are maximized while the administrative burden and uncertainty are minimized?

Viewpoint is designed to bring to the readers of Tax Features *concise opinions from experts in tax and fiscal policy on questions that are currently being debated by policymakers and the media. Editorial replies are encouraged.*

High-Low from page 1

repealed or limited by the new law. Adjusted gross income rose to over $3 trillion for the first time. Taxpayers reported receiving larger amounts of certain types of income, especially partnership and S Corporation net income, property, dividend, pension and annuity income. Taxable income from Social Security income showed a hefty 15.8 percent increase over 1987, reaching $14.5 billion.

The number of returns showing itemized deductions dropped 3.8 million. This was largely due to the increased standard deduction allowed for 1988 and the continued phase-out of "passive losses." The deductibility phase-out of personal interest helped foster a $13.6 billion increase in taxable interest income.

At the bottom line, 1988 total individual income tax rose a hefty 12.7 percent over 1987 for a record $416.1 billion take. At the aggregate, taxes as a percentage of adjusted gross income increased slightly from 13.3 percent to 13.4 percent of AGI. A greater proportion of income was taxed at the highest rate in 1988 because much of the increase in AGI occurred in the higher income classes. This also resulted in the upper income groups' paying a greater percentage of the overall tax collections in 1988.

The top 5 percent of earners nearly doubled their average tax payment, from $17,407 in 1979 to $34,788 in 1988. The top 10 percent paid an average $21,573, 88 percent higher than in 1979. While this group of only 11 million earners paid well over half the total income taxes in 1988, their adjusted gross income ranged down to $58,368, not exactly "fat cat" status. It still takes millions of middle and upper-middle income taxpayers to pay the bulk of the total income tax bill.

Federal Income Taxes Paid by High and Low-Income Taxpayers, 1979 and 1988[a]

Adjusted Gross Income Class	Income Level		Percent of Tax Paid		Average Tax	
	1979	1988	1979	1988	1979	1988
Highest 5%	$39,000 or more	$73,757 or more	37.6%	45.9%	$17,407	$34,788
Highest 10%	32,710 or more	58,368 or more	49.5	56.9	11,456	21,573
Highest 25%	21,760 or more	35,609 or more	73.1	77.8	6,769	11,797
Highest 50%	11,870 or more	18,145 or more	93.2	94.5	4,315	7,163
Lowest 50%	11,869 or less	18,144 or less	6.8	5.5	313	416
Lowest 25%	5,565 or less	7,006 or less	0.5	0.6	46	87
Lowest 10%[b]	2,212 or less	2,178 or less	c	c	9	22

[a] Data for 1988 are preliminary.
[b] Includes returns showing no adjusted gross income.
[c] Less than .07 percent.
Source: Tax Foundation computations based on Statistics and Income, Internal Revenue Service, U.S. Department of the Treasury.

1988 Income Tax Data

Adjusted Gross Income Class	Total Individual Returns (thousands)	Total Adjusted Gross Income ($billions)	Percent of Adjusted Gross Income	Average Tax Rate
Highest 5%	5,490	$894.7	28.9%	21.3%
Highest 10%	10,981	1,223.0	39.5	19.4
Highest 25%	27,452	1,951.7	63.0	16.6
Highest 50%	54,904	2,673.5	86.3	14.7
Lowest 50%	54,904	423.8	13.7	5.4
Lowest 25%	27,452	71.1	2.3	3.3
Lowest 10%[a]	10,981	-17.1	-	-

[a] Includes returns showing no adjusted gross income.
Source: Tax Foundation computations based on Statistics and Income, Internal Revenue Service, U.S. Department of the Treasury.

Mark Your Calendars

The Tax Foundation's
42nd Annual Conference
and 53rd Annual Dinner
Waldorf-Astoria Hotel
in New York City
on December 5, 1990

IRET Seminar To Focus on U.S. Foreign Tax Policy

On October 4, 1990, the Institute for Research on the Economics of Taxation will host an all-day conference in conjunction with Arthur Andersen on U.S. tax policy's current treatment of foreign investment. See schedule below for all pertinent information.

"U.S. Foreign Tax Policy: America's Berlin Wall"

October 4, 1990
Washington Court Hotel
Washington, DC

8:00 **Registration & Continental Breakfast**

8:30 **Welcome & Opening Remarks**
Norman Ture, President, IRET

8:40 **Challenges & Opportunities for American Business & for Public Policy in an Expanding World Economy**
Overview
CEO (to be announced)

9:15 **Economic Potential in Expanding World Markets**
J.D. Foster, Legislative Assistant, Tax Policy, Sen. William Armstrong (R-CO)

10:00 **Problems & Opportunities Arising from EC'92 and the Democratization of Eastern Europe**
Congressman Tom Campbell (R-CA) (inv.)
Murray Schlussel, Asst. General Counsel, International Tax, Ford Motor Co.

10:45 **Break**

11:00 **Tax Policy to Address the Challenges & Opportunities of the Growing World Marketplace**
Norman B. Ture, President, IRET
George Carlson, Director, Economics of Taxation, Arthur Andersen

12:30 **Luncheon Address — Tax Policy to Enhance American Competitiveness**
The Honorable Robert Mosbacher, Secretary of Commerce (inv.)

2:00 **U.S. Foreign Tax Policy and American Business Competitiveness in the Global Marketplace**
Overview
Andre P. Fogarasi, Managing Director, Office of Federal Tax Services, Arthur Andersen
Richard A. Gordon, Director, International Tax Services, Arthur Andersen

2:30 **High-Tech Manufacturing**
Richard Ise, Vice President & Tax Counsel, SmithKline Beecham (inv.)
Bob Perlman, Vice President, Tax, Licensing and Customs, Intel Corp.

3:00 **Other Manufacturing**
John L. Loffredo, Chief Tax Counsel, Chrysler Corporation
Albert E. Germain, Vice President - Taxes and Tax Counsel, Alcoa

3:45 **Service Industries**
Noelle Harwerth, Vice President & Chief Tax Officer, Citicorp

4:15 **Adjourn**

To register, call Kate Watson at 202-347-9570

Tax Foundation Forms Research Planning Groups

Three Tax Foundation program committee members will play a more active role in guiding the Foundation's research. James P. Bryant, vice president and director of corporate taxes at J.C. Penney Company, will be the head of a task force exploring new opportunities for research into tax administration, compliance and simplification. Mr. Bryant was instrumental in sponsoring the Foundation's recent seminar in Dallas, where two panel discussions addressed aspects of the Internal Revenue Code's complexity and current accounting trends.

Haskell Edelstein, senior vice president and general tax counsel for Citicorp/Citibank, U.S.A., will head up a task force guiding the Foundation's research effort in the area of state and local fiscal policies.

The third area of research for which the Foundation is forming a task force is multinational taxation, with John J. Ross, general tax counsel for Chevron Corporation, as its head. Taxation of multinationals will be addressed at the Foundation's upcoming seminar on September 25.

By working with the program committee's two chairmen, Robert F. Hannon, retired director of government relations for Arthur Young & Company, and Glenn W. White, retired director of tax department and assistant secretary at The Dow Chemical Company, these tax executives will help the Foundation fulfill its mission of monitoring taxation and fiscal policy at all levels of government, a task rendered all the more difficult by the tremendous complexity of the code.

Thomas M. Macioce

Thomas M. Macioce, financial leader and longtime friend of the Tax Foundation, died August 3 at Columbia-Presbyterian Medical Center. He was 71 years old and lived in Brookville, NY.

Former chairman and chief executive officer of Allied Stores, Mr. Macioce spent 27 years with the company and was credited with its resurgence during the 1970s.

PRESIDENT'S MESSAGE

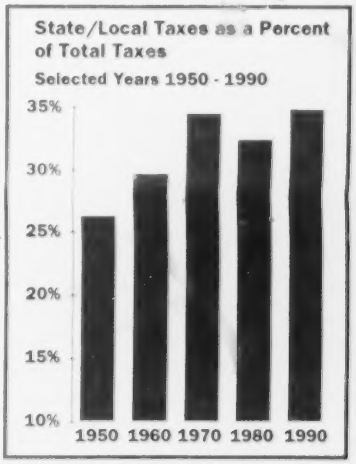
Growing State and Local Taxes Demand More Public Scrutiny

Wayne Gable

An oft-repeated statistic here in Washington warns that federal taxes as a percentage of GNP will break the 20 percent barrier in 1990. Only two years in the last forty, 1968 and 1981, have seen federal spending dominate the economy to this extent. This trend is alarming indeed, but Americans need not look as far as Washington for an example of growth in government.

State and local government taxes have increased much faster than federal taxes over that same forty-year period, from 6.10 percent of GNP in 1950 to 10.75 percent in 1990. State and local taxes now constitute over a third of the total taxes collected (see chart below). This surge should prompt attention from the national media, but state-level tax issues are difficult to cover from a national perspective. Composed of fifty different state histories and hundreds of different stories within each of those fifty, state-level taxation cannot be analyzed in a sound-bite. The complexity of state taxes even imposes itself on federal taxes, as it did in the recent controversy over a proposal to eliminate the deduction for state and local income taxes. Clearly this would constitute a hart hit on citizens whose states rely most on that particular tax relative to states with no individual income tax.

Since tax increases at the state and local levels are presented as solutions to specific problems that citizens are painfully aware of, such as inadequate education, health care and corrections, these taxes have risen steadily. If these states now had excellent schools, good hospitals and efficient prisons, then tax increases might enjoy more popular support. But since the numerous tax increases don't seem to have fixed these problems, perhaps the next time a tax increase is proposed to solve a problem, taxpayers will demand solutions that do not require more tax revenue.



The Tax Foundation has just issued a state by state survey of state tax collections and rates. It tells how much per $1,000 of personal income each state exacts in tax collections. Then in examining tax collections by type, it breaks out the components of state tax collections, sales tax, personal income tax, etc. Earlier this year in our annual Tax Freedom Day report, we noted that the average American worked 43 days simply to earn enough to pay his state and local taxes. This average encompassed a range from 23 days in New Hampshire to 60 days in Hawaii.

As the burden of state taxes weighs more and more heavily on taxpayers, they will need more and more information to make their decisions. The Tax Foundation recognizes that state tax issues are exceedingly complex and require more and better research. We will continue to bring out accurate, timely state-by-state analysis to fill that need.

Tax Foundation Seminar Addresses U.S. Tax Treatment Of Inbound and Outbound Foreign Investment

Congressmen Hank Brown (R-CO) and Phil Crane (R-IL), both of the House Ways and Means Committee, will speak at the Tax Foundation's September 25 seminar entitled "Assessing U.S. Tax Policies Toward International Investment — An Opportunity for Change." The half-day seminar (see schedule below) will be followed by an informal cocktail reception.

The seminar is divided into four panel discussions, two on U.S. tax policy toward investment coming into the United States from foreign countries, and two on how we tax investments abroad by U.S.-based firms. The latest thinking from the foremost international tax experts will be brought to bear on the daunting challenge posed by the globalization of the world economy to U.S. tax policy.

For more information, please call Paul Merski or Cynthia Herrle at 202-863-5454.

"Assessing U.S. Tax Policies Toward Foreign Investment – An Opportunity for Change"

September 25, 1990, at the Washington Court Hotel on Capitol Hill in Washington, DC

12:00 Registration/Light Fare

12:30 Welcome
Wayne Gable, President, Tax Foundation

Keynote Address
Congressman Hank Brown (R-CO), House Ways and Means Committee

Issue Overview
Edward M. Graham, Senior Fellow, Institute for International Economics

1:00 Session #1: Tax Treatment of U.S. Investment Abroad

Panel Chairman: David Crowe, Partner, Caplin & Drysdale

Raymond Haas, International Tax Partner, Ernst & Young

Murray Schlussel, Asst. General Counsel, International Tax, Ford Motor Co.

Panel Chairman: Robert Mattson, Assistant Treasurer, IBM

Richard M. Hammer, International Tax Partner, Price Waterhouse

B. Anthony Billings, Tax Foundation Senior Research Fellow & Associate Professor of Accounting, Wayne State University

John F. Brussel, Tax Director - International, AT&T

2:30 Break

2:45 Session #2: Tax Treatment of Foreign Investment in the U.S.

Panel Chairman: Robert Ashby, Asst. Vice President, Taxes, Northern Telecom Inc.

Congressman Philip M. Crane (R-IL), House Ways and Means Committee: Trade, Ranking Minority Member

Elliot L. Richardson, Senior Partner, Milbank, Tweed, Hadley & McCloy

James Merle Carter, Senior Tax Counsel, ICI Americas

Bruce R. Bartlett, Deputy Asst. Secretary for Economic Policy, U.S. Department of the Treasury

Panel Chairman: John Wilkins, Partner, Coopers & Lybrand

Catherine T. Porter, Partner, Miller & Chevalier, Chartered

Peter Barnes, Deputy International Tax Counsel, U.S. Department of the Treasury

Harrison J. Cohen, Legislation Counsel, Joint Committee on Taxation

Richard Pratt, Economic Counsellor, Embassy of Great Britain

5:15 Cocktail Reception

To register, call Cynthia Herrle at 202-863-5454

Tax Features

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Vice President ..... Dan Witt
Director of Fiscal Affairs .... Paul G. Merski
Senior Fellow ..... B. Anthony Billings
Senior Fellow ..... Carlos Bonilla
Editor ..... William Ahern

Tax Foundation
470 L'Enfant Plaza, S.W.
Suite 7112
Washington, D.C. 20024
202-863-5454

470 L'Enfant Plaza, S.W.
Suite 7112
Washington, DC 20024

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U.S. Postage
PAID
Washington, DC
Permit No. 2979

Mr. Ed Kianka
Acquisitions Editor
4520 East-West Highway
Bethesda, MD 20814-3389